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Report to the Chairman, Subcommittee on Military Readiness, Committee on Armed Services, House of Representatives

December 1999

AIR FORCE DEPOT MAINTENANCE

Analysis of Its Financial Operations

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United States General Accounting Office
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Accounting and Information
Management Division

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December 10, 1999

The Honorable Herbert H. Bateman
Chairman
Subcommittee on Military Readiness
Committee on Armed Services
House of Representatives

Dear Mr. Chairman:

The Air Force depot maintenance activity group supports combat readiness by providing the depot repair services necessary to keep Air Force units operating worldwide. The group repairs and overhauls a wide range of assets including aircraft, missiles, aircraft engines, electronics, avionics, software, and repairable inventory items for military services, other government agencies, and foreign governments. For example, in fiscal year 1998, the Air Force reported that the depot maintenance activity group performed major overhauls on about 670 aircraft, overhauled about 980 engines, and repaired more than 800,000 inventory items. The group generates about $5 billion in annual revenue of which about $3.5 billion comes from in-house repair and services and about $1.5 billion comes from its contract repair operations.

This report, one in a series[1] you requested on the financial operations of the Department of Defense's (DOD) Working Capital Funds, addresses the Air Force depot maintenance activity group. This group operates under the working capital fund concept, where customers are to be charged the anticipated actual costs of providing goods and services to them.

As requested, this report discusses (1) the Air Force depot maintenance activity group's price increase between fiscal year 1994 and fiscal year 1999 and the primary reasons for it, (2) the activity group's financial losses during fiscal year 1994 through fiscal year 1998 and the primary reasons for them, and (3) the Air Force's methods for recovering these losses. We

[1]We issued two reports on the Navy Ordnance activity group (GAO/AIMD/NSIAD-97-74, March 14, 1997, and GAO/AIMD/NSIAD-98-24, October 15, 1997) and two reports on the Air Force Supply Management Activity Group (GAO/AIMD/NSIAD-98-118, June 8, 1998, and GAO/NSIAD/AIMD-99-77, April 29, 1999).

briefed your office on the results of our work on September 15, 1999. As agreed, we are continuing our work and will evaluate the Air Force's ability to develop accurate estimates for work to be accomplished, material costs, and anticipated savings that were used in developing depot maintenance prices.

Results in Brief

The Air Force depot maintenance activity group's prices increased from an average of $92.60 per direct labor hour (DLH) in fiscal year 1994 to $128.43 per DLH in fiscal year 1999—a 39 percent increase.[2] The price increase occurred primarily because (1) the direct material cost per direct labor hour increased, (2) workload declined faster than overhead costs, and (3) the average cost of civilian labor increased.

Even though the prices increased 39 percent, the Air Force reported that the depot maintenance activity group lost about $623 million[3] during fiscal years 1994 through 1998 on total sales of about $21.8 billion. Our analysis indicates that these losses occurred primarily because the activity group (1) did not accomplish as much work as expected, (2) had material costs that were higher than budget estimates, (3) developed prices based on anticipated savings that were not realized, and (4) incurred losses on its contract repair operations during fiscal years 1996, 1997, and 1998.

Since fiscal year 1995, the Air Force has tried different methods to recover the depot maintenance activity group's losses with varying success. For fiscal years 1995 through 1997, the Air Force increased prices and requested a direct appropriation. However, neither of these methods was successful in recouping losses. Beginning in fiscal year 1998, the Air Force used the following two other methods, which were more successful in recovering losses.

- First, the Air Force developed the depot maintenance activity group's fiscal years 1998 and 1999 prices based on the group's cost of operations plus an amount to recover $310 million in prior year losses. The Air Force then separated the approved fiscal years 1998 and 1999 prices into

[2]If the fiscal year 1994 price is converted to fiscal year 1999 dollars, it would be $106.58 per DLH. This would reduce the increase to 20.5 percent.

[3]The $623 million loss includes a $98.8 million accounting adjustment that does not need to be recovered.

two pieces. The first piece was the amount the activity group charged individual customers for current year work. The second piece was to recover the $310 million in prior year losses.

- Second, pursuant to a new DOD policy that directs depot maintenance activities to recover losses that occurred during the year of execution, the Air Force (1) reprogrammed funds and (2) used other available customer appropriated funds to recover the depot maintenance activity group's losses. As a result, the Air Force recovered or plans to recover $313.4 million in losses that occurred in fiscal years 1998 and 1999.

Background

The Air Force depot maintenance activity group is part of the Air Force Working Capital Fund, a revolving fund that relies on sales revenue rather than direct congressional appropriations to finance its operations. Working capital funds are to (1) generate sufficient revenue to cover the full costs of their operations and (2) operate on a break-even basis over time—that is, not make a profit nor incur a loss.

The activity group generates revenue by billing customers at predetermined, fixed prices as it performs specifically agreed-upon work for those customers. The prices are to be based upon anticipated actual costs. DOD customers primarily use operations and maintenance appropriations to pay for the work. Payments from customers replenish the Air Force Working Capital Fund's working capital, which is used to finance subsequent operations. The activity group is expected to operate within the revenue it generates. Conceptually, this provides an incentive to control costs and maximizes efficiency. It is essential that the activity group operates efficiently since every dollar spent inefficiently results in fewer funds available for other defense spending priorities.

Developing accurate prices is challenging since the prices are developed about 2 years in advance of when the work is actually received and performed. In essence, the activity group's budget development has to coincide with the development of its group's customers' budgets so that they both use the same set of assumptions. To develop prices, the activity group estimates (1) labor, material, overhead, and other costs based on anticipated demand for work as projected by customers, (2) total direct labor hours for each type of work to be performed, such as aircraft, engines, and repairable items, (3) the workforce's productivity, and (4) savings due to productivity and other cost avoidance initiatives.

Since the early 1990s, the depot maintenance activity group has undergone downsizing, accomplished through annual reductions-in-force and "early outs." For instance, from fiscal years 1992 through 1999, the Air Force cut the activity group's workforce by 23 percent (7,000 workers). The activity group was further affected by the work of the 1993 and 1995 Base Realignment and Closure Commissions, which resulted in decisions to close two of the Air Force's five air logistics centers and the Aerospace Guidance and Metrology Center.

DOD and the Air Force have also made several major policy and other changes that affected the depot maintenance activity group's costs, prices, and work performed since the early 1990s. Air Force officials stated that (1) both costs and the prices set to recover those costs have been significantly affected by changes in the scope and mix of workload to be performed and (2) the depot maintenance activity group's costs have increased due to the aging of the aircraft and engines. Table 1 shows these changes have occurred throughout the 1990s.

Table 1: Policy and Other Changes Affecting the Depot Maintenance Activity Group's Prices, Costs, and Workload

Fiscal year	Policy and other changes
1992	Establishment of the Defense Business Operations Fund required recovery of full costs in the activity group's prices.
1992 and 1993	The financing of repairable inventory items in the stock fund increased the activity group's material costs because the group did not pay for these items prior to this change.
1992 through 1999	In response to the declining force structure and the increasing amount of work that is being contracted out, the Air Force reduced the number of activity group employees from about 31,000 in fiscal year 1992 to about 24,000 in fiscal year 1998. This affected the experience and skills of workers as well as the amount of work that could be performed by the depots.
1993 to 1997	The Air Force converted its existing three level depot maintenance operations (organization, intermediate, and depot) to two levels (organization and depot) for selected avionics and engine items. Since the engine work was very material intensive, the average material cost per hour and the average customer price per hour both increased.
1993 to present	The process of closing two air logistics centers and the Aerospace Guidance and Metrology Center and transferring their work to other sources of repair reduced both the amount of work performed and the productivity of the workforce at these activities.
1998	The Air Force changed the method of pricing inventory items sold to customers, including the depot maintenance activity group, which affected the group's material costs.
1998 and 1999	About one-third of the group's workload was scheduled to be competed or realigned, which affected the location and the amount of work performed by the depots and resulted in a major hiring and training requirement at the gaining activities.

Scope and Methodology

To determine what factors caused the prices to increase between fiscal year 1994 and fiscal year 1999, we obtained and analyzed budget documents that provided information on cost factors, such as material costs, overhead costs, and salaries used in developing the prices. We discussed the reasons for the price increases with Air Force officials located at headquarters and the Air Force Materiel Command.

To determine what factors caused the activity group to incur losses from fiscal year 1994 through fiscal year 1998, we obtained and analyzed budget documents and accounting information that provided information on budgeted and actual direct costs, overhead costs, workload expressed in direct labor hours (DLH), and productivity. When variances occurred between budgeted and actual reported information, we met with responsible budgeting and accounting officials to ascertain why there were differences and how the differences resulted in losses. To determine how the Air Force recovered the activity group's reported losses, we obtained budget and accounting information on the amount of the losses and

analyzed the methods used by the Air Force to finance those losses. We discussed the different methods for recovering losses with Air Force officials located at headquarters and the Air Force Materiel Command to determine why they used several different methods.

We did not verify the accuracy of the accounting and budget information used in the tables and charts in this report, all of which was provided by the Air Force in then-year dollars. We are continuing our work and will report separately on the Air Force's ability to develop accurate estimates of workload, material costs, and anticipated savings that were used in developing depot maintenance prices.

We performed our work at the headquarters, Office of the Under Secretary of Defense (Comptroller) and the Office of the Secretary of the Air Force, Washington, D.C.; Air Force Materiel Command, Dayton, Ohio; the Oklahoma City Air Logistics Center, Tinker Air Force Base, Oklahoma; the Ogden Air Logistics Center, Hill Air Force Base, Utah; the San Antonio Air Logistics Center, Kelly Air Force Base, Texas; the Sacramento Air Logistics Center, McClellan Air Force Base, California; the Warner Robins Air Logistics Center, Robins Air Force Base, Georgia; and the Defense Finance and Accounting Service, Arlington, Virginia.

Our work was performed from May 1999 through October 1999 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Secretary of the Air Force or his designee. On November 10, 1999, the Depot Maintenance Program Manager provided us with oral comments. These comments are discussed in the "Agency Comments" section of this report.

Factors Causing Prices to Increase

The depot maintenance activity group's composite sales price[4] increased from $92.60 per DLH in fiscal year 1994 to $128.43 per DLH in fiscal year 1999, an increase of about 39 percent.[5] As shown in table 2 and discussed below, almost all of this price increase can be attributed to three factors: (1) direct material costs per DLH increased, (2) workload declined more

[4]The composite sales price is the average price that customers must pay for a DLH of work.

[5]The fiscal year 1994 information is in then-year dollars. If the fiscal year 1994 price is converted to fiscal year 1999 dollars, it would be $106.58 per DLH. This would reduce the increase to 20.5 percent.

rapidly than overhead costs and, as a result, more overhead costs had to be allocated to each DLH of work accomplished, and (3) the average cost of civilian labor increased.

Table 2: Primary Reasons for the Air Force Depot Maintenance Activity Group's Fiscal Years 1994 and 1999 Sales Price Increase

Reason	Increase in the price per DLH	Percent of total
Direct material cost per DLH increased	$14.28	39.8
Workload declined faster than overhead costs	$13.01[a]	36.3
Average cost of civilian labor increased	$7.76	21.7
Other	$.78	2.2
Total	**$35.83**	**100.0**

[a]The actual increase was $16.04 per hour, but $3.03 is not included because it resulted from an increase in the average cost of civilian labor (which is a separate reason).

Direct Material Costs Have Increased

Our analysis showed that the depot maintenance activity group's budgeted direct material costs have declined much less than its budgeted workload. Specifically, the activity group's workload (expressed in DLHs) declined nearly 35 percent between fiscal year 1994 and fiscal year 1999 due to reductions in the Air Force's force structure, along with other factors such as the increased use of contractors. However, its direct material costs declined less than 4 percent. As a result and as shown in table 3, direct material costs per DLH increased $14.28, about 48 percent.

Table 3: Budgeted Direct Material Costs per DLH for Fiscal Year 1994 and Fiscal Year 1999

	Fiscal year		Change	
Description	**1994**	**1999**	**Amount**	**Percent**
Direct material costs (in millions)	$1,029.7	$992.2	$(37.50)	(3.6)
DLHs (in millions)	34.421	22.451	(11.97)	(34.8)
Direct material costs/DLH	$29.91	$44.19	$14.28	47.7

Air Force depot maintenance officials stated that the increase in budgeted direct material costs per DLH can be attributed to (1) higher material costs and (2) increased material usage. Further, they stated that there is more than one underlying cause for both of these factors. Part of the cost increase can be attributed to inflation. Most of it, however, is attributable to the fact that, in 1998, the Air Force supply management activity group began charging specific customers the full cost of replacing condemned inventory items (broken items that cost more to fix than to replace). In the past, these costs were spread evenly to all customers. According to Air Force officials, the net effect of this change was that some costs shifted from other supply management activity group customers, such as Air Force units, to the depot maintenance activity group.

Air Force depot maintenance officials also stated that material usage has increased because (1) the workload mix now includes more work that has relatively high material costs[6] and (2) factors such as the aging of the aircraft and engine inventory is causing them to replace more component parts when repairs are accomplished. However, these depot maintenance officials acknowledge that they (1) do not yet fully understand the effect of the various factors that have affected their material costs in recent years and (2) need to develop a better understanding of these factors if they are to effectively manage their material costs. They also said that the Air Force is making a concerted effort to develop this better understanding.

[6]For example, engine work, which has higher material costs than most workloads, increased from 5.6 percent of the budgeted total in fiscal year 1994 to 12.5 percent in fiscal year 1999.

Workload Decline Has Outpaced Overhead Reduction

Reductions in the Air Force's force structure, along with other factors such as increased use of contractors, have reduced the amount of work accomplished by the depot maintenance activity group's depots. However, the depots' overhead costs have not decreased proportionately to the decline in the workload. As a result, the depots have had to allocate more overhead costs to each DLH of work they accomplished. Specifically, as summarized in table 4, the need to allocate overhead costs over a steadily declining workload base has caused the amount of budgeted overhead costs allocated to each budgeted DLH of work accomplished to increase from $33.38 in fiscal year 1994 to $49.42 in fiscal year 1999, an increase of about 48 percent.

Table 4: Budgeted Overhead Cost per DLH for Fiscal Year 1994 and Fiscal Year 1999

			Change	
Description	Fiscal year 1994	Fiscal year 1999	Amount	Percent
Overhead costs (in millions)	$1,149.1	$1,109.5	$(39.60)	(3.4)
DLHs (in millions)	34.421	22.451	(11.97)	(34.8)
Overhead cost/DLH	$33.38	$49.42	$16.04	48.1

According to Air Force depot maintenance officials, prices in general and overhead cost in particular should decline after July 2001, when the Air Force expects to finish closing two depots and transferring their workload to other depots and contractors.

Average Cost of Civilian Labor Has Increased

An increase in the average cost of civilian labor increased the depot maintenance activity group's prices by $7.76 per DLH for fiscal year 1994 through fiscal year 1999, about $3.03 for overhead labor and $4.73 for direct labor. This increase was due to higher costs for both salaries and benefits. Specifically, as shown in table 5,

- budget estimates for the average annual cost of employee compensation (for basic salary and such variable costs as holiday and overtime pay) increased by $5,752 per work year per employee, 15.5 percent over 5 years and

- budget estimates for the average annual cost of employee benefits (employer contributions for such things as health and life insurance) increased by $2,147, or 29.1 percent over 5 years.

Table 5: Average Budgeted Cost of Civilian Labor for Fiscal Year 1994 and Fiscal Year 1999

Description	Fiscal year 1994	Fiscal year 1999	Change: Amount	Change: Percent
Average employee compensation	$37,175	$42,927	$5,752	15.5
Average employee benefits	$7,375	$9,522	$2,147	29.1
Average compensation and benefits	$44,550	$52,449	$7,899	17.7

Factors Contributing to the Activity Group's Financial Losses

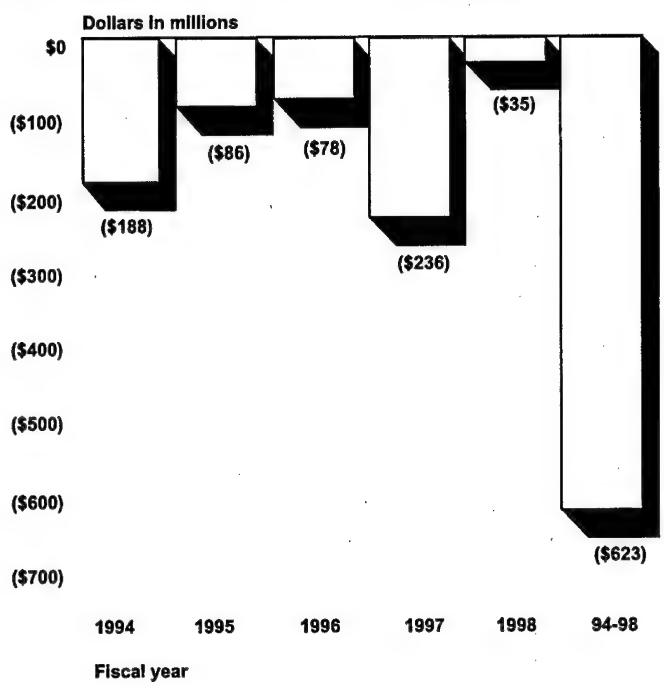
The Air Force depot maintenance activity group reported that it lost about $623 million from fiscal years 1994 through 1998. Although many factors contributed to these financial losses, our analysis indicates that they occurred primarily because (1) the activity group did not accomplish as much work as expected (budgeted) and was, therefore, unable to fully recover its fixed overhead costs, (2) material costs were higher than budget estimates, (3) prices were based on anticipated savings that were subsequently determined by the Air Force to be overly optimistic, and (4) the activity group incurred losses on its contract repair operations during fiscal years 1996, 1997, and 1998.

Projected Operating Results Have Consistently Been Overly Optimistic

DOD policy requires that the depot maintenance activity group operate on a break-even basis over time. However, from fiscal year 1994 through fiscal year 1998, the activity group incurred losses every year. The activity group did not achieve its goal of operating on a break-even basis during this period chiefly because it consistently developed overly optimistic estimates for the activity group's net operating results. For example, the activity group was budgeted to earn a profit of about $200.1 million in fiscal year 1998.[7] However, instead of making a profit, the activity group reported that it lost about $35 million during the year. Figure 1 shows the activity group's reported net operating results for fiscal years 1994 through 1998.

[7]This budget was submitted to the Congress in February 1997.

Figure 1: Air Force Depot Maintenance Activity Group's Reported Actual Net Operating Results for Fiscal Years 1994 Through 1998



Lower Than Budgeted Production Levels Prevented Full Recovery of Overhead Costs

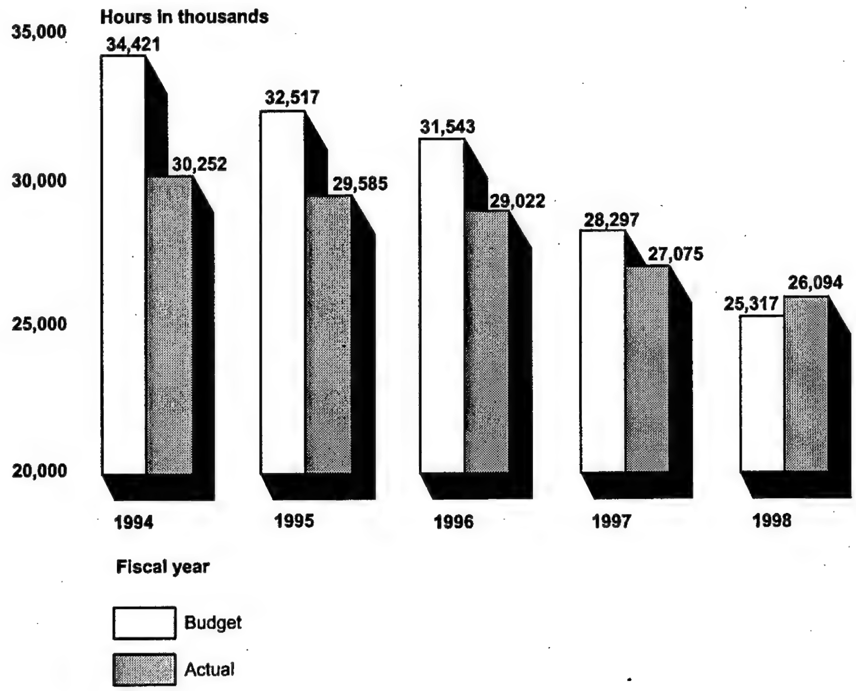
The Air Force depot maintenance activity group lost about $374 million from fiscal years 1994 through 1998 because its workers accomplished fewer DLHs of work than budgeted and because this, in turn, prevented it from fully recovering its overhead costs. Air Force depot maintenance officials stated the following.

- Overhead costs for such things as the salaries of administrative personnel are generally fixed costs in the year of execution and therefore do not vary significantly with the amount of work accomplished during the year.
- When prices are developed approximately 2 years in advance of actual work being accomplished, overhead costs are allocated on a prorated share to each DLH of work expected to be accomplished in the year of execution (i.e., in essence, each hour of work they accomplish pays for a certain amount of overhead costs). When workload does not materialize, regardless of the reason, DOD's price stabilization policy

prohibits the activity group from increasing prices to make up for the shortfall.

Figure 2 shows that the number of budgeted DLHs declined from 34.4 million in fiscal year 1994 to 25.3 million in fiscal year 1998—a 9.1 million (26 percent) DLH reduction. Even though the Air Force reduced the budgeted DLHs each year from fiscal year 1994 through fiscal year 1998, our analysis showed that the amount of work actually accomplished during this 5 year period was still 10.1 million DLHs less than the budgeted amount. Figure 2 shows the budgeted and actual DLHs for the 5-year period.

Figure 2: Depot Maintenance Activity Group's Budgeted and Actual Production for Fiscal Years 1994 Through 1998

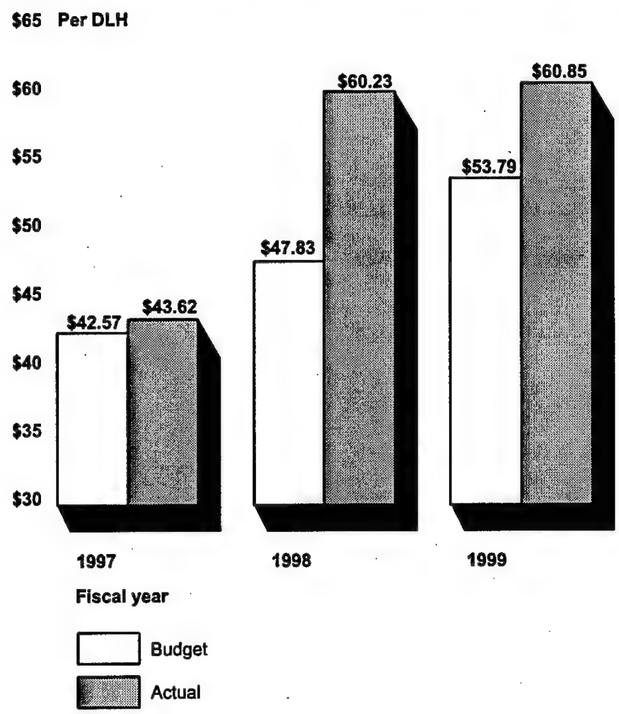


Activity Group Had Higher Than Budgeted Material Costs

The activity group's reported actual material cost per DLH was $16.61, about 38 percent higher in fiscal year 1998 than the previous fiscal year. Further, as shown in figure 3: (1) in fiscal year 1998, the reported actual material cost per DLH was $12.40, about 26 percent higher than the budgeted amount and (2) although the Air Force increased the budget estimate for material cost per DLH by $5.96 in fiscal year 1999, the reported actual costs have been even higher.[8] According to Air Force officials, these increases were driven by a number of changes in the Air Force's pricing policy for depot-level repairables in order to more accurately distribute costs to customers. The changes had the net effect of distributing a larger share of material cost to depot maintenance and a smaller share to other Air Force activities.

[8]Actual fiscal year 1999 data are a straight-line projection of actual data for the first 10 months.

Figure 3: Air Force Depot Maintenance Activity Group's Budgeted and Reported Actual Material Costs per DLH for Fiscal Years 1997 Through 1999



The higher than budgeted material cost per DLH caused the activity group's fiscal year 1998 material costs to be $324 million higher than budget estimates.[9] However, material costs per DLH of work accomplished vary significantly from one workload to another, and a determination of the effect of these higher material costs on the activity group's financial operating results would require a detailed analysis of individual workloads.

Recognizing that this is an area that needs more management attention, the Air Force Materiel Command is beginning to implement metrics to develop a better understanding of why material costs are increasing and how the Command can better control and reduce material costs. This is a good step

[9]Reported actual material costs were $360.8 million higher than the budgeted amount, but part of the difference was due to higher than budgeted production.

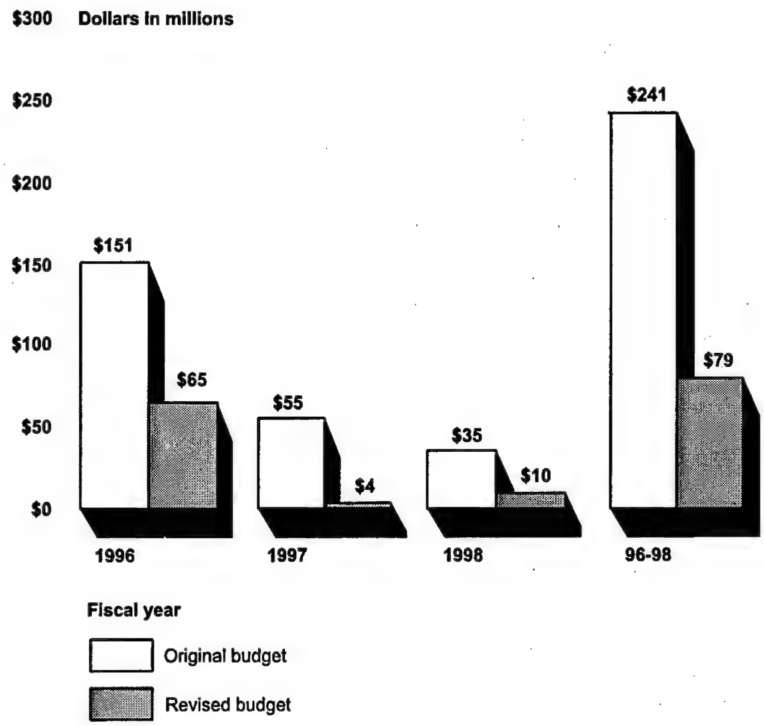
toward ensuring that decisionmakers have the information they need to manage the activity group as a business operation.

Anticipated Budget Savings Did Not Materialize

Another major contributor to the activity group's financial losses has been its failure to achieve cost reduction and productivity improvement goals that were incorporated into budget estimates. We could not determine how much the activity group actually saved on individual initiatives because activity group managers do not track and document actual savings.[10] However, a comparison of initial budget estimates for savings (which are used to develop prices) and revised budget estimates provides a good indication that the savings are not being achieved. Specifically, as shown in figure 4, in recent years, the initial budget estimate for savings has repeatedly been reduced in the revised budget estimate, which is developed the following year based on updated information.

[10]Our report, entitled *Air Force Depot Maintenance: Management Changes Would Improve Implementation of Reform Initiatives* (GAO/NSIAD-99-63, June 25, 1999), discussed that the Air Force does not have a system for tracking savings.

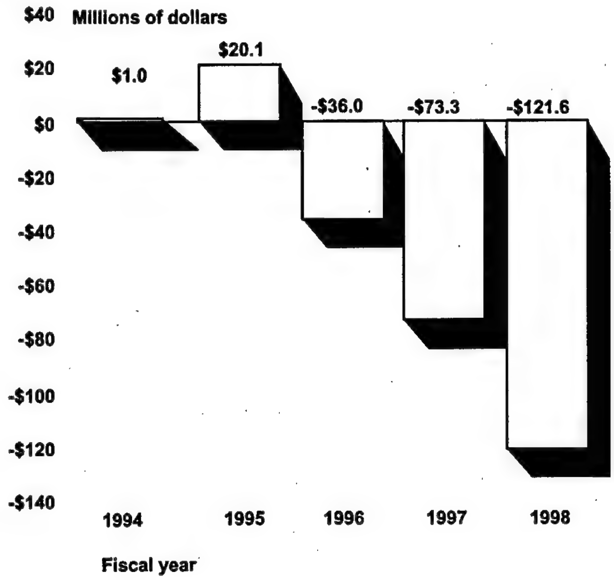
Figure 4: Comparison of Initial and Revised Budget Estimates for the Air Force Depot Maintenance Activity Group's Savings for Fiscal Years 1996 Through 1998



Contract Operations Have Lost Money in Recent Years

As shown in figure 5, the activity group's contract operations reported a net operating loss of about $210 million during fiscal years 1994 through 1998, a profit of about $21 million during the first 2 fiscal years, and a loss of $231 million during the last 3 fiscal years.

Figure 5: Air Force Depot Maintenance Activity Group's Reported Actual Net Operating Results From Its Contract Operations for Fiscal Years 1994 Through 1998



Although figure 5 indicates that the activity group's financial performance on its contract operations has declined steadily since fiscal year 1995, the results are distorted by a $98.8 million "accounting" loss in fiscal year 1998. This loss occurred because the Air Force changed its accounting policy on valuing inventory located at contractor plants and inventory in transit from the contractors to the Air Force.[11] Since this loss was due to the revaluation of inventory and not due to actual losses resulting from operations, the Air Force, with Office of the Under Secretary of Defense (Comptroller) approval, did not recover this loss in its prices. Without this change in accounting policy, the reported fiscal year 1998 loss would have been $22.8 million rather than $121.6 million.

[11]Prior to 1998 (1) the activity group paid the full (standard) price for repairable items provided to contractors, (2) items at contractor plants were valued at standard prices, and (3) the activity group was credited for the carcass value (standard price less exchange price) when broken items were returned to supply. Under the new policy (1) the activity group pays the exchange price (standard price less carcass value) for items provided to contractors, (2) the value of items at contractor plants is based on exchange prices, and (3) the activity group receives no credit when contractors return broken items to supply.

Most of the activity group's other contract losses were caused by problems related to the management and control of government-furnished material provided to contractors. For example, one air logistics center lost about $18.8 million on a single contract because of numerous material-related control problems, including (1) Air Force records showed that more material was shipped to a contractor than was received by the contractor and (2) material that was supposed to be on hand at the contractor's facilities was not found.

Air Force Has Tried Different Methods to Recover Activity Group Losses

Over the last 5 years, the Air Force has tried four different methods to recover the activity group's losses. For fiscal years 1995 and 1996, prices the group charged individual customers for work were increased to recover losses. For fiscal year 1997, rather than increase prices, the Air Force requested an appropriation to recover losses but the request was denied by the Congress. In fiscal years 1998 and 1999, the Air Force used two different methods to recover the activity group's losses. First, the Air Force separated approved customer prices into two pieces: an amount charged individual customers for work performed in the current year and an amount used to recover $310 million in prior year losses. Under the second method, the activity group recovered or plans to recover $313.4 million in losses in the fiscal year they occurred. Air Force officials told us that the activity group will have about $30.5 million in accumulated operating losses at the end of fiscal year 1999. These losses occurred during fiscal year 1999 (primarily in the last quarter) and the Air Force plans to recover them during fiscal year 2000.

Fiscal Years 1995 and 1996 Prices Increased to Recover Losses

DOD policy[12] requires depot maintenance activities, as well as other working capital fund activities, to operate on a break-even basis over time. To do this, working capital funds are to establish prices that would allow them to recover from their customers the expected costs of operations, as well as any prior years' losses. In accordance with this policy, the Air Force increased the activity group's fiscal years 1995 and 1996 customer prices in an attempt to recover prior year losses. However, even though the prices were increased, the activity group reported losses of about $86 million and $78 million in fiscal years 1995 and 1996, respectively.

[12]DOD's *Financial Management Regulation, Volume 11B, Reimbursable Operations, Policy and Procedures—Defense Business Operations Fund,* Chapter 50, page 50-2.

Appropriation of $194.5 Million Requested in Fiscal Year 1997 to Recover Losses

Although the general practice has been to recover losses through increasing the prices charged customers, DOD policy also allows losses to occasionally be recovered by a direct appropriation. In its fiscal year 1997 budget submission to the Congress, rather than increasing prices, the Air Force requested that $194.5 million be appropriated to its Operations and Maintenance account to specifically recover the activity group's accumulated operating losses. The Operations and Maintenance funds were then to be transferred (called a pass through) to the activity group.

In its budget submission to the Congress, the Air Force stated that the requested appropriation was necessary to reduce the impact of external events that were beyond its control on the activity group's prices. The Air Force stated that the DOD force structure reduction initiatives caused workforce turmoil (unexpected workload losses, skilled labor imbalances, and multiple job changes) that undercut budgeted productivity and efficiency goals. The Air Force further stated that the $194.5 million pass through was essential to the liquidity of its working capital fund and protected customers from unacceptable future price increases.

The Congress denied the Air Force's request for the pass through. In reviewing the request, the House Appropriations Committee stated that DOD has had a policy of recovering prior year operational losses through adjustments (increases) in prices. The Committee further stated that it generally supported the policy of recovering losses through prices, and since DOD requested a pass through to recover losses, the Committee was concerned that DOD may be making a significant shift in policy. The Congress subsequently reduced the Air Force's fiscal year 1997 budget submission by the $194.5 million requested.

Prior Year Losses Recovered by Separating Fiscal Years 1998 and 1999 Prices Into Two Pieces

Activity group customer prices that were approved by DOD for fiscal years 1998 and 1999 and submitted to the Congress in the Air Force's budget justification books included an amount to recover $310 million in prior year losses. According to Air Force officials and budget documents, these losses were related to the closing of two depot maintenance activities (San Antonio and Sacramento) and force structure reductions. To ensure that the prior year losses were recovered, the Air Force separated the group's approved prices into two pieces. The first piece was the amount or price the group charged customers for current year work. The second piece—the difference between the approved price and the actual price charged customers—was the amount to be used to recover the $310 million in prior year losses in fiscal years 1998 and 1999.

The funds representing the difference between the approved prices and the prices actually charged customers—$176 million to be recovered in fiscal year 1998 and $134 million to be recovered in fiscal year 1999—were accounted for at Air Force headquarters and have been or will be provided to the depot maintenance activity group. The Air Force sent project orders to the activity group to recover these losses. By using this method, the Air Force was able to help ensure that the activity group received or will receive the funds to recover the prior year losses.

Losses Recovered in the Fiscal Year They Occurred

For many years, DOD has had a policy of recovering prior year losses through increased customer prices for future work. Starting in fiscal year 1998, DOD changed this policy for its depot maintenance activities. DOD now requires unbudgeted losses to be recovered in the year they occur by adding a surcharge to individual customer's bills. An unbudgeted loss is the difference between a depot maintenance activity's net operating results that were estimated in its budget and the actual net operating results experienced in the current year.

DOD changed its policy because it believed this would (1) encourage depots to initiate cost controls more rapidly, (2) provide the right incentives to set prices correctly, and (3) eliminate the routine use of advance billing to cover execution losses.[13] This policy helps to control costs because it puts pressure on the Air Force to ensure that the depot maintenance activity group sets prices correctly.

The Air Force followed DOD's policy change in fiscal years 1998 and 1999, and as a result, its depot maintenance activity group collected or plans to collect $313.4 million from customers to recover unbudgeted losses during these 2 fiscal years—$182.6 million and $130.8 million in fiscal years 1998 and 1999, respectively. However, rather than adding a surcharge to customers' bills as required by DOD's new policy, the Air Force used project orders to specifically recover the losses. Customers (major commands) sent project orders to the depot maintenance activity group which then, in turn, billed for the amount on the orders to recover the losses.

[13]Since 1993, the defense working capital funds have experienced a cash shortage and have had to advance bill customers for work not yet performed in order to ensure that the funds' cash balances remained positive.

To help Air Force customers pay the activity group their portion of the losses related to current year work orders, the Air Force transferred $134.6 million in fiscal year 1998 and $80.5 million in fiscal year 1999 from its Procurement, Military Personnel and/or Research, Development, Test and Evaluation appropriations to Air Force customers' Operations and Maintenance appropriation. According to Air Force officials, the remaining $98.3 million in unbudgeted losses was related to prior year orders, the work for which was performed in the current year. To pay the activity group for these losses, Air Force customers used prior year funds that financed the orders that were still available for obligation.

Conclusions

Over the past 5 years, the Air Force depot maintenance activity group has not been able to meet its financial goal of operating on a break-even basis. Even though the activity group increased its prices 39 percent, the activity group reported losses of $623 million. These losses primarily occurred because the Air Force did not develop accurate estimates of its expected material costs, direct labor hours to be performed, and anticipated savings that were used in developing prices. Beginning in fiscal year 1998, the Air Force began recovering losses in the year that they occurred. As a result, the activity group will be closer to breaking even at the end of fiscal year 1999 than it has in the past 5 years.

The Air Force is also beginning to implement management metrics to develop a better understanding of why material costs are increasing and how they can be better controlled. While this is a good step toward ensuring that decisionmakers have the information they need to manage the activity group as a business operation, it will be important for the group to also develop metrics for other key factors such as workload, overhead costs, and anticipated savings. Our subsequent review will assess the effectiveness of existing metrics and provide additional perspective on the need for other measures.

Agency Comments

Air Force officials provided comments on previous briefings on the results of our work. These comments were incorporated in this report as appropriate. In providing oral comments on this report, Air Force officials agreed with our findings and conclusions.

We are sending copies of this report to Representative Solomon P. Ortiz, Ranking Minority Member, Subcommittee on Military Readiness, House Committee on Armed Services; Senator John Warner, Chairman, and Senator Carl Levin, Ranking Minority Member, Senate Committee on Armed Services; Senator Ted Stevens, Chairman, and Senator Daniel K. Inouye, Ranking Minority Member, Subcommittee on Defense, Senate Committee on Appropriations; and Representative Jerry Lewis, Chairman, and Representative John P. Murtha, Ranking Minority Member, Subcommittee on Defense, House Committee on Appropriations. We are also sending copies of this report to the Honorable William S. Cohen, Secretary of Defense, and the Honorable F. Whitten Peters, Secretary of the Air Force. Copies will also be made available to others upon request. If you have any questions about this report, please call Mr. Greg Pugnetti, Assistant Director, at (202) 512-6240. Other key contributors to this report are listed in appendix I.

Sincerely yours,

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